IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF REVERSAL

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STATEMENT OF INTEREST

The Chamber of Commerce of the United States ("the Chamber") is a nonprofit corporation organized and existing under the laws of the District of Columbia. The Chamber is the largest business federation in the United States. Its membership consists of over 67,000 businesses, the great majority of which are corporations, and more than 3,700 state and local chambers of commerce and trade associations, which in turn have numerous corporate members. Many of these corporations are engaged in the manufacture or distribution of goods for which an inventory of replacement parts is an essential business practice.

The central issue in this case is one that has plagued the administration of the income tax laws since the day of their conception. It concerns, in the context of inventory valuation, reconciling established principles of financial accounting with the doctrine of the clear reflection of income, both of which are explicitly endowed with equal statutory authority. The Chamber seeks a definitive resolution of this pervasive and recurring issue to secure for its large membership of business taxpayers the benefits of certainty, precision and efficiency in the increasingly complex task of reporting taxable income.[1]

SUMMARY OF ARGUMENT

In recognition of the premise that financial accounting is devoted to the accuracy of period economic results, Congress has, since 1916, conferred upon proper accounting a decidedly influential effect upon the calculation of federal income taxes. Even more explicitly, this statutory preference for proper accounting has existed without interruption since 1918 with respect to inventory valuation.

Under this statutory scheme, the results of financial reporting in conformity with accepted accounting principles should be held to satisfy the demands of annual tax accounting. In addition to fulfilling the statutory preference for the best accounting procedures, the method of inventory valuation applied by the taxpayer here clearly reflects income. The dispositive element as it affects the income equation is realistic appraisal of the market value of ending inventory. The taxpayer relied upon objective business experience, validated by the scrutiny of accounting experts, to derive the expected return from its excess inventory. The requirements of actual market or closed transactions asserted by the Commissioner of Internal Revenue ("Commissioner") posit artificial and strained impediments that subvert overriding statutory and policy objectives.

1. The Chamber does not address the bad debt issue presented in this case.

In these circumstances, the statutory framework does not afford the Commissioner any broad discretion to simply set aside an accepted accounting rule. Where an accounting method and the accurate reporting of periodic financial results converge, as here, the method should be sustained even if predicated upon formulated estimates derived from business experience. Numerous rules of both financial and tax accounting are the function of reasonable economic assumptions, a factor which should confirm, rather than defeat, their shared objectives. In short, the sensible administration of the tax laws yields only the narrow authority of the Commissioner to disallow, under an appropriate standard, taxpayer's accounting method, or in a rare circumstance a prevalent accounting rule which demonstrably distorts income.

Finally, in discharging this statutory function, the administrative action of the Commissioner should adequately reveal the reasoning process to assure its substantive validity. Increasingly, this Court in varied administrative contexts has imposed the procedural duty upon the administrator to adequately explain governmental action for the purpose of exposing substantive policy and to assure an informed judicial review. There is no basis to excuse the Commissioner from these minimal requirements considering the scope and gravity of his discretionary determinations.

ARGUMENT

I. Congress Deliberately Chose Sound Accounting Methods as the Principal Calculus for Income Taxes

Following the constitutional authorization of the Sixteenth Amendment, Congress enacted in 1913 the first in a series of income tax codes, which was the rudimentary beginning for the present statute. Revenue Act of 1913, 38 Stat. 114. The original act imprecisely taxed "accrued" income which soon proved unworkable for lack of sufficient definition. Revenue Act of 1913, § IIB, 38 Stat. 167. *See generally* May, *Account-*

ing and the Accountant In the Administration of Income Taxation, 47 Col. L. Rev. 377 (1947).

With the extraordinary necessity for revenue and for a broad tax base prompted by the First World War, the Revenue Acts of 1916 and 1918 superseded the prior formula by adopting the general prescription that taxable income was to be computed in accordance with a taxpayer's regularly employed method of accounting, so long as income was not distorted. Revenue Act of 1916, § 13(d), 39 Stat. 756, 771; Revenue Act of 1918, § 212(b), 40 Stat. 1057, 1064-1065. This statutory tenet remains substantially unchanged in what is now Section 446[2] of the Internal Revenue Code of 1954.[3]

Of significance to this case, in passing the Revenue Act of 1918 Congress further declared that, with respect to inventory valuation, the method prescribed should conform as nearly as may be to the "best accounting practice in the trade or business and as most clearly reflecting the income." Revenue Act of 1918, Section 203, 40 Stat. 1060. These same standards have been in force for the last 60 years. See I. R. C. § 471.[4] The

2. Section 446 reads in relevant part as follows:

General Rule for Methods of Accounting.

"(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

I. R. C. § 446.

3. Unless otherwise indicated, all section references in this brief are to the Internal Revenue Code of 1954, 26 U. S. C. §§ 1 *et seq.* (1970).

4. Section 471 reads in full as follows:

General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the

(Footnote continued on next page.)

legislative decision introduced in these provisions, and proposed by prominent accountants of the day, was an unmistakable acceptance of accounting principles designed to eliminate the confusion of prior tax laws. *See generally* May, *supra.*

Congress, of course, did not indiscriminately endorse every method of accounting at the sacrifice of the accurate depiction of income. The contrast of the language in Sections 446 and 471, however, is instructive in this regard. Under Section 446, a taxpayer's regular method of accounting may not be disturbed unless it distorts income, even though it is out of step with generally accepted accounting principles. Obviously, an accounting method, though regular, but nonetheless in conflict with an accepted accounting rule may indeed and often will misstate income. In that circumstance, the Commissioner can and should have the discretion to invoke a different method. The question remains, however, whether Congress ever intended to empower the Commissioner with the roving license to invalidate accounting methods that comply with accepted accounting principles dedicated to financial accuracy. In short, there is the fundamental question addressed herein of whether there is any distinction between realistic financial accounting and the clear reflection of income and, if so, how that distinction is determined and acted upon.

But apart from the precise interpretation of Section 446, Congress chose crucially different words for Section 471. As stated, the Commissioner was granted appropriate authority in Section 446 to supplant regular but unaccepted accounting methods to clearly reflect income. Beyond that, neither the statutory language nor the legislative history of Section 446

(Footnote continued from preceding page.)

income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

offer specific focus on the role of accepted accounting principles in the administrative process.[5] The Commissioner's authority under Section 471, however, is decidedly more confined in prescribing inventory valuation methods. The provision explicitly enjoins the Commissioner to devise a method that conforms both to the "best accounting practice"[6] and "as most clearly reflecting the income". The legislative history of Section 471, moreover, emphasizes a clear preference for accepted accounting standards as determinative except in instances of patent abuse.[7] While Section 471 may suggest some difference between best accounting and the clear reflection of income, it is manifest that the statute does not permit the Commissioner, with no explanation, to simply select one at the expense of the other. Equally important, there is every indication, as Part II demonstrates, that the method of inventory valuation employed by the taxpayer here does clearly reflect income, leaving the administrative determination with no substantive foundation.

II. An Inventory Valuation Method That Implements a Realistic Appraisal of Market Value Does Clearly Reflect Income

The income formula for a business with a physical inventory is critically affected by the method of ascribing value to the goods

5. In reenacting this provision in the 1954 Code, Congress did note:

> A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income.

S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954), *reprinted in* [1954] U. S. Code Cong. & Ad. News 4939. *See also* Treas. Reg. 1.446-1(a)(2) (1957).

6. The phrase "best accounting practice" has been uniformly construed as equivalent to generally accepted accounting principles. *See, e.g., Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144, 151 (5th Cir. 1963).

7. *See* 61 Cong. Rec. (Part 6) 5809 (1921), quoted in relevant part in the Petitioner's Brief Part I.-A.

or material on hand at the end of a fiscal period. The ending inventory has a direct, inverse relation to reportable income.

A long settled precept of accounting, unequivocally adopted by the income tax regulations, states that ending inventory shall equal the lower of cost or market value. Treas. Reg. § 1.471-2 (c) (1958). The theoretical underpinning of this rule recognizes that a decline in the economic utility of goods available for sale is and should be attributed as a cost during the period in which the decline occurs. Even though the decline in value is unrealized by any transaction, the rule correctly assesses the economic fact that the operation is incurring a deficit to the extent a business produces goods during a given interval at a cost greater than expected return. If the rule failed to heed that reality, accounting would hardly fulfill its function of accurately informing a business of the economic results of its period activity.

Market value that expresses the dynamics of the marketplace has historically been a cardinal tradition for valuation of inventories in our tax framework. *See United States Cartridge Co.* v. *United States,* 284 U. S. 511 (1932). Adherence to this approach as commanded by relevant accounting standards is of signal importance in valuing excess inventory. In this case, the taxpayer had engaged in the common practice of producing multiple quantities of 44,000 individual replacement parts in excess of what subsequent experience demonstrated could be sold. This business decision was dictated by the inability to predict for each item the repair or replacement incidence. Concomitantly, the prohibitive cost of retooling for future supply dictated the excess production of replacement parts with the components of the integral product with which they are associated.

On this record, it is undisputed that the empirical business experience of this taxpayer demonstrated the inevitable fact that a large proportion of the entire inventory would never be sold. For this reason, there was abundant and uncontradicted testimony in the trial court that generally accepted accounting prin-

ciples required a writedown to net realizable value, that is, the amount of revenue reasonably expected from the disposition of these items. In the end, the accounting principle properly confirmed that this business incurred a measurable cost in producing an excess supply. That cost was the result of a deliberate and unavoidable business decision necessary to equip the enterprise with the ability to service the finished products it sold. Moreover, actual experience subsequent to the taxable years in issue furnished remarkable validity to the predicted value.[8] (A. 88-91.)[9] To ignore this period cost in the income equation would seriously misstate earnings.

Despite the demonstrated effort of the taxpayer and its accountants to reliably report the results of operations, the Commissioner and the Court of Appeals rejected taxpayer's method. First, the Court of Appeals recited a perceived but unarticulated distinction between tax and financial accounting as justification for its holding. (Pet. A. 40.)[10] This view is premised largely upon the supposition that financial accounting is dedicated to the balance sheet, a relic of a bygone era which the accounting profession has consistently repudiated. The rules of accounting and its practitioners have been increasingly sensitive to earnings, which is of foremost concern to shareholders, investors and other recipients of certified financial statements.[11] More important, it is one thing to say that, upon careful scrutiny and by objective standards, a given accounting rule fails to achieve income accuracy. It is quite another, as was the case here, to rely upon this litany of a difference without more to discard an accounting method designed to clearly reflect income.

8. Although the validity of an accounting method may not be sustained solely upon what occurs after the taxable year, such evidence is instrumental in evaluating the merits of the prediction:

> While subsequent events are not determinative of a fact on a given date prior thereto, that which occurred . . . confirms what would have been a reasonable expectation at that time. . . .

Space Controls Inc. v. *Commissioner,* 322 F. 2d 144, 155, n. 24 (5th Cir. 1963), *quoting Lucker* v. *United States,* 53 F. 2d 418, 424 (Ct. Cl. 1931).

9. "A." refers to the Appendix filed herein.

10. "Pet. A." refers to the appendix to the Petition in which the opinion of the Court of Appeals is reprinted.

11. The governing principles of accounting, adopted after extensive deliberation by the profession, have long ascribed paramount consideration to the accuracy of period income. AICPA Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", ch. 2, ¶ 12 (1970); AICPA Accounting Research Bulletin No. 43, "Introduction", ¶ 3 (1953).

With regard specifically to inventory valuation, the accounting principles compel selecting the method which "most clearly reflects periodic income." *Id.* ch. 4 at Statement 4, *and at* ch. 4, Statement 7.

To indiscriminately suggest, in light of the above, that generally accepted accounting principles and tax accounting do not share common objectives unfairly dismisses an entire body of considered judgment.

Second, the Court of Appeals held that taxpayer's method was not authorized by the inventory regulations. (Pet. A. 41-45.) That holding, however, assumes a rigid and unyielding interpretation of the regulations while subverting the aims of the statute. Three Courts of Appeals confronted with the same issue in related contexts have each held that market realities, not a slavish construction, is the touchstone in applying the regulations. *Monfort of Colorado, Inc.* v. *United States,* 561 F. 2d 190 (10th Cir. 1977); *E. W. Bliss Co.* v. *United States,* 351 F. 2d 449 (6th Cir. 1965), *aff'g* 224 F. Supp. 374 (N. D. Ohio 1963); *Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144 (5th Cir. 1963).

As discussed in the taxpayer's brief filed herein (Pet. Br. Part I.-G.), the regulations provide examples rather than an exhaustive catalogue of market conditions. The Chamber will not repeat the cogent arguments of the taxpayer which show excess inventory is economically indistinguishable from unsalable goods described in the regulations. Suffice it to say that

at worst, the regulations do not preclude taxpayer's method while the statute compels it.[12]

When the technical features of the regulations are put aside, the issue distills to whether taxpayer's method realistically calibrates market value. Nothing in the Commissioner's obscure determination, or in the views espoused by the Court of Appeals, raises serious question whether the inventory declined in value below its cost. At bottom, what is disputed is the method to measure that decline in value. The taxpayer relied upon undisputed business experience fortified by highly qualified accounting expertise. On the other hand, the Commissioner argued and the Court of Appeals agreed that the decline could only be realized by actual market transactions, including scrap sales. That reasoning defies analysis. If there had been an index of an open market for these parts, the decline in value would have been allowed without the formal necessity of realization or physical disposition. Yet, the unique characteristics of these parts by definition precluded an open market. To insist in this situation upon the formalistic and artificial act of attempted sales of these parts in the absence of any market effectively defeats the legitimate purpose of excess replacement parts with no corresponding benefit. In substance, the decision of the Court of Appeals in requiring a "closed transaction" is akin to contending that the only way of proving that a mushroom is not a toadstool is to eat it.

12. To the extent the regulations are deemed intractable as construed by the decision of the Court of Appeals, they necessarily collide with the relevant statute. Although the Chamber disagrees with the notion that there is no room in the regulations for taxpayer's method, it is clear that the regulations should be held invalid rather than elevated to a position superior to and in conflict with the statute upon which they depend.

III. The Relevant Statutes Circumscribe the Commissioner's Latitude to Displace an Established Accounting Rule

As heretofore demonstrated, the accounting rule at stake here is not only generally accepted in the field of expertise, but it stands on its own merits as the best empirical index of the peculiar market for replacement parts. Accordingly, it amply satisfies the command of the relevant statutes as a method that clearly reflects income while constituting the best accounting practice.

The administrative determination in this case posits the question of whether and to what extent Congress ever intended to grant the Commissioner discretion to disallow an established accounting principle solely because, in the Commissioner's judgment, it distorts income. This issue was raised but not definitively resolved in this Court's decisions in *American Automobile Ass'n.* v. *United States,* 367 U. S. 687 (1961) (hereafter cited as "*AAA*") and *Schlude* v. *Commissioner,* 372 U. S. 128 (1963), both of which involved the application of Section 446.

Prior to those decisions, the statutory predecessors of Section 446 had a varied history in the courts. Several decisions by this Court and by lower courts effectively equated realistic accrual accounting with acceptable tax reporting, particularly with respect to expenses. *See, e.g., Continental Tie & Lumber Co.* v. *Commissioner,* 286 U. S. 290 (1932); *United States* v. *Anderson,* 269 U. S. 422 (1926); *Denise Coal Co.* v. *Commissioner,* 271 F. 2d 930, 934-937 (3d Cir. 1959); *Pacific Grape Products Co.* v. *Commissioner,* 219 F. 2d 862 (9th Cir. 1955); *Uncasville Manufacturing Co.* v. *Commissioner,* 55 F. 2d 893, 895 (2d Cir. 1932), *cert. denied,* 286 U. S. 545 (1932). While there was an occasional reference to financial and tax accounting, the decisions disallowing a taxpayer's accounting invariably found it wanting in reliability or accuracy. *See, e.g., Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957); *Lucas* v. *Kansas City Structural Steel Co.,* 281 U. S. 264 (1930); *Lucas* v. *American Code Co.,* 280 U. S. 445

(1930). Indeed, the pattern of decisions is consistent with a reading of Section 446 that limits the Commissioner to disallowing a taxpayer's accounting which distorts income by departing from the same principles followed by established accounting.

Against this historical backdrop, the taxpayers in *AAA* and *Schlude* sought to defer prepaid income for services by spreading the receipts ratably over the period when the services were to be performed for the customer. The taxpayer's method was conceded to be in accord with generally accepted accounting principles. A five to four majority of the Court in both cases upheld the Commissioner's discretionary disallowance upon two grounds. First, the Court found that, since customer demand for future service was potentially erratic, allocating income ratably in the future was an "artificial" accounting method vulnerable to the Commissioner's discretion. *AAA*, 367 U. S. at 690-694; *Schlude*, 372 U. S. at 135-137. The second ground of the decisions, which the Court concluded firmly supported the first, was the enactment and subsequent repeal within one year of Sections 452 and 462 of the Internal Revenue Code of 1954.[13] *AAA*, 367 U. S. at 694-698; *Schlude*, 372 U. S. at 134-135. In particular, Section 452 would have permitted the precise tax accounting which taxpayers sought in *AAA* and *Schlude*. *AAA*, 367 U. S. at 694. Surveying the ambiguous legislative history of this short-lived statute, the Court in *AAA* and *Schlude* discerned a congressional decision to segregate this issue for further legislative consideration and action.[14]

13. 26 U. S. C. §§ 452, 462 (1952 ed. Supp. II), repealed 69 Stat. 134 (1955).

14. In enacting Section 452, Congress expressed its disapproval of court decisions which generated disparity and confusion between financial and tax accounting. *See* H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48, *reprinted in* [1954] U. S. Code Cong. & Ad. News 4073. That general intent of Congress to promote uniformity of financial and tax accounting was not dissipated by the repeal of Section 452. For even under the majority opinion in *AAA*, that repeal simply reflected a legislative decision to isolate prepaid income for further Congressional action.

Because of the exceptional legislative measures respecting prepaid income, the implications of *AAA* and *Schlude* should be confined to that discrete area.

To the extent that the majority opinions in *AAA* and *Schlude* promote the notion that an accounting method predicated upon reasonable estimates derived from business experience may be undone in the Commissioner's discretion, that proposition should not be extended beyond the facts of those cases. Hardly a rule of accounting exists, whether it be dubbed tax or financial, that does not depend upon an accurate assessment of past events as the basis for assaying the future. In the area of bad debts, depreciation, worthless stock, accrual income, to name a few, accrual tax consequences are essentially estimates based upon historical evidence. The ideals of certainty and reliability in our self-assessment system are too elemental to permit developed procedures of measure to be swept aside in favor of unfettered administrative power.[15]

In a subsequent prouncement of the relation between tax and financial accounting, this Court held that despite *AAA* and *Schlude* generally accepted accounting principles are not to be lightly displaced. *Commissioner* v. *Idaho Power Co.*, 418 U. S. 1 (1974). In *Idaho Power Co.*, the taxpayer was urging tax treatment at odds with established accounting rules which were also imposed by the Federal Power Commission to which the taxpayer was subject. This Court noted with respect to *AAA*:

> In . . . [AAA] it was observed that merely because the method of accounting a taxpayer employs is in accordance

15. The fact that the taxpayer here found it impractical or impossible to separately evaluate the oversupply factor for each of 44,000 parts is inconsequential. With respect to the analogous situation of pinpointing accrued liabilities, courts have held that a deduction will be allowed for a group of liabilities analysed as a whole even though individual liabilities could not be identified. *Lukens Steel Co.* v. *Commissioner*, 442 F. 2d 1131 (3d Cir. 1971); *Washington Post Co.* v. *United States*, 405 F. 2d 1279 (Ct. Cl. 1969). In both those cases, a deduction for an employee benefit fund was allowed even though the amount of the fund was statistically estimated and the identity of the particular recipients and the time of payment was yet to be fixed. *See also Gillis* v. *United States*, 402 F. 2d 501 (5th Cir. 1968).

> with generally accepted accounting principles, this "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury". . . . Nonetheless, where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences.

Commissioner v. *Idaho Power Co.*, 418 U. S. at 15 (emphasis in original; citations omitted.) Although the business of the taxpayer in this case is not generally subject to the same broad regulatory scheme as a public utility, its publicly disseminated income reports are subject to financial disclosure rules of the Securities and Exchange Commission. The SEC has traditionally required registrants to adhere to established accounting principles and has further declared that unsubstantiated deviations would be deemed presumptively "misleading". *See* Securities & Exchange Commission Accounting Series Release No. 4 (April 25, 1938); Securities & Exchange Commission Accounting Series Release No. 150 (December 20, 1973). What is more, a contrast with *Idaho Power Co.* illustrates the harsh anomoly of the Commissioner's position here in seeking to create a vast discretionary domain to freely accept or reject established accounting rules whenever a revenue advantage is perceived. That result does sharp violence to the inventory statute which uniquely places the value of best accounting on the same plane as the clear reflection of income.

Most recently in *Frank Lyon Co.* v. *United States*, ... U. S. ...., 46 U. S. L. W. 4313 (U. S. April 18, 1978), this Court considered the effect of the taxpayer's adherence to accepted accounting principles in assessing the Commissioner's contention that a sale-and-leaseback lacked economic substance. The parties' uniform adherence, the Court observed, "gave the transaction a meaningful character consonant with the form it was given." 46 U. S. L. W. at 4318. This Court did not suggest in *Lyon*, nor does the Chamber contend here, that adherence to generally accepted accounting principles is necessarily dispositive. Rather, the critical point is that tax reporting which adheres to accounting conventions should enjoy protection from undefined administrative discretion in the absence of a contrary statute or of a distortion of income clearly articulated by the Commissioner.

In this case measuring a decline in inventory value under the Commissioner's disallowance would exchange a practical, recognized rule for the ritual of scrapping the disputed items. Indeed, the Commissioner's near-sighted insistence in detaining the loss until excess inventory is physically discarded portends the very abuse his position avows to curb. At the time when a taxpayer could individually identify the unneeded replacement parts, the loss by scrapping could be incurred or postponed to maximize tax advantages, irrespective of any compunction to clearly reflect income. The irony of that result would be a loss of both the certainty sought by taxpayers and the revenues sought by the Commissioner.

In sum, this Court should restore to this case the abiding congressional intent since 1916 which denies the Commissioner any discretion to disturb a taxpayer's reported income if executed in accordance with realistic accounting procedures. This Court should further hold that generally accepted accounting principles constitute realistic accounting procedures unless the Commissioner can explain and show that a particular established rule has an objective and result that conflict with period income. Such a decision does not require an act of faith, for it is recognized that accounting, like every other human endeavor, is not an absolute or perfect science. As one astute commentator has stated:

> The enactment of Section 212[16] of the Revenue Act of 1918 and the discussions to which it gave rise undoubtedly

16. Section 212 is the predecessor of Section 446 of the present Code.

> contributed to a wider recognition of the fact that accounting is not an exact science based on inexorable laws, but a method of analysis and classification based on postulates and conventions which leads to conclusions the merit of which is that they are useful and indeed almost essential in the conduct of business.

May, *Accounting and the Accountant in the Administration of Income Taxation,* 47 COL. L. REV. 377, 387 (1947).

A pronouncement by this Court, which rightfully grants to established accounting rules the probity intended by Congress, would provide the stability Justice Jackson found deplorably wanting in another setting:

> [C]onflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law.

Dobson v. *Commissioner,* 320 U. S. 489, 499 (1943). *Accord, Brown* v. *Helvering,* 291 U. S. 193, 204-205 (1934) ("It is not the province of the court to weigh and determine the relative merits of systems of accounting.")

In short, this case presents the profound policy choice of whether certainty, precision, and clarity in the administration of the tax laws is more important than affording the tax administrator the awesome power to disarrange accounting systems for no other reason than to enlarge the revenues.

IV. The Commissioner's Exercise of Discretion Should Be Subject to Procedural Safeguards

However the Commissioner's discretion is defined, it is untenable that it should be exercised with no procedural safeguards calculated to assure substantive content. In this case, after an elaborate administrative process and upon reaching the Tax Court, this enormous adjustment by the Commissioner was explained in a cursory statement. (A. 3.) In the Tax Court, no

evidence was offered by the Commissioner, much less any criteria of what constitutes the clear reflection of income. (A. 207.) As a result, the Tax Court's holding on this central issue was, as the Court of Appeals candidly but uncritically noted, "without elaboration." (Pet. A. 41.) Indeed, the only justification for the Commissioner's action in all these proceedings including in his opposition to a writ of certiorari in this Court has consisted solely of the rationalization of government counsel.[17]

Increasingly, this Court and the Courts of Appeals in reviewing a wide variety of administrative action have imposed minimum procedural requirements upon the several federal agencies. As demonstrated below, these requirements have been formulated whether or not the Administrative Procedure Act[18] was applicable and despite how broad the agency's discretion and how lean the judicial review of it.[19] What is curious is how the Commissioner has apparently managed to escape these strictures when considering, as Chief Justice Marshall suggested,[20] that the power to dip into a taxpayer's pocketbook can be as devastating as any governmental action. Moreover, like any other federal agency, the Commissioner is but a surrogate of Congress where the constitutional power resides.

17. Even then, the government has chiefly asserted that a wooden construction of the regulations at odds with market realities and dominant statutory objectives should ordain the outcome here.

18. 5 U. S. C. §§ 551, *et seq.* (1970).

19. *See generally,* K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES, ch. 16, pp. 377 *et seq.*, Supplement, ch. 16, pp. 133 *et seq.* (1976). As Professor Davis has noted, the Administrative Procedure Act is essentially a codification of prior (and still valid) decisional law principally of this Court.

20. "[T]he power to tax involves the power to destroy . . ." *McCulloch* v. *Maryland,* 17 U. S. 316, 431 (1819). The eloquent modification of that aphorism by Justice Holmes is perhaps more fitting here:

> The power to tax is not the power to destroy while this Court sits.

Panhandle Oil Co. v. *Mississippi,* 277 U. S. 218, 223 (1928) (dissenting opinion).

On repeated occasions in differing administrative settings, this Court and lower courts have insisted that an agency furnish an adequate explication of its action. *See, e.g., Dunlop* v. *Bachowski*, 421 U. S. 560, 571-577 (1975) (Secretary of Labor required to give reasons for refusing to institute action to set aside union election); *Wolff* v. *McDonnell*, 418 U. S. 539, 564-565 (1974) (prison officials required to give reasons for disciplinary action); *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U. S. 402 (1971) (Secretary of Transportation required to give reasons for highway route selection); *Kitchens* v. *Department of the Treasury*, 535 F. 2d 1197 (9th Cir. 1976) (Bureau of Alcohol, Tobacco and Firearms required to give reasons for denying application for relief from federal disabilities); *Beck* v. *Securities & Exchange Commission*, 413 F. 2d 832 (6th Cir. 1969) (Securities and Exchange Commission required to give reasons for severity of sanctions imposed for broker's misconduct). These decisions were not premised upon any statutory mandate of the APA. Rather, an explanation of agency action has been found to be indispensable to effective judicial review, even if such review is narrow in scope. *See Dunlop* v. *Bachowski*, 421 U. S. 560, 571-577 (1975); *Panama Refining Co.* v. *Ryan*, 293 U. S. 388, 432-433 (1935). Perhaps more critical, the reasons for an agency's policy may assume greater importance than the policy itself:

> [T]he public is vitally concerned with the reasons which did supply the basis for an agency policy actually adopted.

NLRB v. *Sears, Roebuck & Co.*, 421 U. S. 132, 152-153 (1975).

In view of the primacy of these considerations, an agency determination devoid of any articulated basis of reasons cannot be sustained by "*post hoc* rationalizations" of its counsel, *FPC* v. *Texaco, Inc.*, 417 U. S. 380, 397 (1974), or by the creative guesswork of the courts, *Bowman Transportation, Inc.* v. *Arkansas-Best Freights System, Inc.*, 419 U. S. 281, 285-286 (1975). Even under the "arbitrary and capricious" standard of

review, "[t]he agency must articulate a 'rational connection between the facts found and the choice made.'" *Id.* at 285, *quoting Burlington Truck Lines* v. *United States*, 371 U. S. 156, 168 (1962).

There is no reason for the Internal Revenue Service to be exempted from these precepts, for administrative action of the magnitude involved in this case should be exposed to sunlight. The District of Columbia Court of Appeals identified these evolving policies of administrative law which aptly fit the administrative exercise of the taxing power:

> We stand on the threshold of a new era in the history of the long and fruitful collaboration of administrative agencies and reviewing courts. For many years, courts have treated administrative policy decisions with great deference, confining judicial attention primarily to matters of procedure. On matters of substance, the courts regularly upheld agency action, with a nod in the direction of the "substantial evidence" test, and a bow to the mysteries of administrative expertise. Courts occasionally asserted, but less often exercised, the power to set aside agency action on the ground that an impermissible factor had entered into the decision, or a crucial factor had not been considered. Gradually, however, that power has come into more frequent use, and with it, the requirement that administrators articulate the factors on which they base their decisions.

Environmental Defense Fund, Inc. v. *Ruckelshaus*, 439 F. 2d 584, 597 (D. C. Cir. 1971) (footnotes omitted). The court further delineated minimal requirements to assure basic administrative fairness which this Court should hold applicable to the Commissioner's determination here:

> To protect these [societal] interests from administrative arbitrariness, it is necessary, but not sufficient, to insist on strict judicial scrutiny of administrative action. For judicial review alone can correct only the most egregious abuses. Judicial review must operate to ensure that the administrative process itself will confine and control the

> exercise of discretion. Courts should require administrative officers to articulate the standards and principles that govern their discretionary decisions in as much detail as possible. Rules and regulations should be freely formulated by administrators, and revised when necessary. Discretionary decisions should more often be supported with findings of fact and reasoned opinions. When administrators provide a framework for principled decision-making, the result will be to diminish the importance of judicial review by enhancing the integrity of the administrative process, and to improve the quality of judicial review in those cases where judicial review is sought.

Id. at 598 (footnotes omitted). Unless the Commissioner is obliged to detail the reasons for his discretionary acts, there is no way to ascertain whether salient tax policies have been motivated by a principled analysis, by a crass tally of the revenues, or by other extraneous considerations.[21]

CONCLUSION

In 1916 Congress wisely chose to incorporate realistic accounting practices in tax determinations, particularly in respect to inventories. While Congress also conferred appropriate authority upon the Commissioner to fairly fill the interstices of the law, it conferred no power to impose dictates contrary to the overriding policy and statutory objectives.

The Code, after all, is intended to tax real not imaginary financial success. The cost of producing excess inventory parts is no more or less a reasonable estimate of financial fact than the economic assumptions that underly many facets of every tax return. An accounting method that relies and acts upon the

21. The Tax Court, while acquiring more the characteristics of a constitutional court than its original status as an administrative tribunal, does often satisfy the policy of providing stated reasons for tax regulation. However, as the opinion of the Tax court here emphasized (Pet. A. 20-21, 30), it merely conducted a limited judicial review of the inventory issues under a "plainly arbitrary" standard, in deference to the Commissioner's assertedly "broad" discretion.

solid realities of business experience deserves far greater efficacy than was extended in this case.

In behalf of its constituency comprising business taxpayers of every size and description, the Chamber urges this Court to instill confidence and stability in the tax framework by pronouncing a result which affirms the value of established methods of period accounting rather than one which subordinates those methods to the unspoken motives of administrative power.

For all the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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